

The Effect of personality characteristics of financial and executive directors on the quality of financial reporting

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Abstract

This research is to investigate different aspects of personality Characteristics of financial and executive directors and their impacts on accounting information. This research is organized around three themes including examining the effect of financial and executive director's replacement on quality of financial reporting, the effect of managements' too much self-confidence on the output of financial reporting, finally the effect of financial and executive directors' sex on the output of financial reporting. Through considering objective samples, this research tries to study the importance of personality characteristics of financial and executive directors as an important factor on outputs of financial reporting. This study also attempts to present a new insight into improving the quality of corporating governance and financial reporting. Finally, it shows that without considering the personality characteristics of financial and executive directors, the structure of corporating governance in each firm cannot maximize the stockholders wealth.

Keywords: personality characteristics, corporating governance, sex, quality of financial reporting, financial and executive directors

Introduction

Identifying the personality characteristics of executive directors is one of the important issues. According to academicians, chief executive directors in each organization are significant and have an effective role in determining major goals and how to deal with quick technological advances and con-

textual changes (Hillery & Hsu, 2011). In contrast, some scholars believe that context is effective on the performance of executive directors and, in turn their abilities for influencing organization performance are restricted. As an example of organizational culture, the fixed kind of assets and industry influence abilities of executive directors in dealing with events which organization encounter to (Shawver, Bancroft, & Sennetti, 2006). The results of recent researches reveal that the effectiveness of executive directors on performance of firms is less than the effectiveness of contextual factors and competitors. For example, Libersone *et al.* (1972) showed that the effectiveness of executive directors on performance of the firm is only (6.5%- 14.5%), which is relatively less than contextual factors of competitors (Hennes *et al.*, 2008).

Vaserman *et al.* (2010) argue that there is significant difference between the effectiveness of executive directors and the effectiveness of contextual factors and competitors on performance of firms (Shawver, Bancroft, & Sennetti, 2006). However, Mackey (2008) found strong evidence in favor of the effectiveness of executive directors on the performance of the firm. He considered the performance of the firm as a criterion for measuring the performance of directors. The results also showed that executive directors influence the output of accounting information (Hillery & Hsu, 2011).

Methodology

Executive directors are selected to maximize the expected value of stockholders (Armstrong *et al.*, 2010). Information presented in financial statements allows the external beneficiaries to study the degree

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of effectiveness of executive directors on performance of firms. So providing the informational requirements of external beneficiaries is a suitable incentive to do the operation and reporting correctly. The role of executive directors in identifying and reporting accounting numbers and income is undeniable. Helli (1985) argues that the results of much studies show that income is manipulated by executive directors (Collins *et al.*, 2009), (Habib *et al.*, 2012). According to the obtained results, executive directors put pressure on financial directors into manipulating the income to present a better image of the performance of the firms, when it is necessary (Hermalin *et al.*, 2003). This research is to investigate the effect of personality characteristics of executive and financial directors on the quality of financial reporting.

The firms that manipulate the income to present a better image of the performance of the firm generally have serious problems and even go bankrupt (Malmendier & Tate, 2009). Problems arising from income manipulation could change the executive directors. Executive directors are responsible for the accuracy of the financial statements as well as for any mistakes or fraud in financial statements. Therefore, one of the duties of executive directors is to manage and control the performance of the personnel. In this section, prior research about effective management of human resources reviewed to help improve the performance of directors who present financial statements with low quality. Although these studies are favorable for the market, their effectiveness is influenced by the personality characteristics of executive directors (Hambrick *et al.*, 2008).

Results of much researches indicate that personality characteristics of executive directors such as too much self-confidence, optimistic predictions, profitability at any cost, and cooperating in fraudulent actions have a significant role in making financial policies like financing, corporating governance, and divisions (Goel & Thakor, 2008). According to the results of many researches, too much self-confidence could be a negative point for directors but it also reflects risk-taking of executive directors to be more profitable. The effect of too much self-confidence highlights the importance of personality characteristics in making corporate governance rules.

Sex is effective on ethical works of executive directors. Some researches indicate that men and women have unique interests and they have differ-

ent tendencies in doing unethical behaviors in business (Betz, 1998). Men are interested in profitability and they are generally successful in achieving that goal. They also like to use a unique leadership style in achieving competitive advantage. However, women are more sensitive to establishing communications and helping others and they are less likely to do unethical actions (Huang *et al.*, 2011). Therefore, sex of executive and financial directors is effective on their reporting.

This research attempts to enrich the quality of financial reporting through analyzing the previous researches. For example, the study of Dechow *et al.* (2010) about the effect of firms on quality of the income was used (Collins *et al.*, 2009). Although this research is about the quality of financial reporting, it tries to pay attention to personality characteristics of executive and financial directors, (i.e. too much self-confidence and gender of directors). So far, a comprehensive research has not yet done about this issue. The research of Armstrong *et al.* (2010) is one of the researches that discusses about lack of transparency of information asymmetries among directors, owners, and its destructive influence on the structure of governance corporating (Armstrong, Guay & Weber, 2010).

This research also gives reasons that information asymmetries among directors and owners could be because of the personality characteristics of executive directors such as orientation, personal tendencies and sex. These issues were not considered in Armstrong *et al.* (2010). Therefore, this research can provide a new insight into the role of executive directors among external and internal beneficiaries. This research also helps future researchers to understand the role of management in accounting and corporating governance, since prior studies did not pay attention to the role of management in accounting, auditing and corporating governance (Hambrick *et al.*, 2008).

The rest of this study is organized as follows. First, it investigates the effect of financial and executive directors' job rotation on the quality of financial reporting and then it tries to answer the question of 'how much does punishing directors guilty of manipulating income effects?' Next, it follows on examining personality characteristics of directors and their effects on information accounting. It also studies the effect of directors' too much self-confidence on financial reporting such as issuing and confirming the expected income and their natural

tendency to do fraudulent activities. Then, it examines the effect of financial and executive directors' sex on the quality of financial reporting through empirical research. Final section presents the related reasons and conclusion.

Results

According to agent theory, directors are considered as stockholders' agents and they are responsible for maximizing stockholders' wealth. However, maximizing stockholders' wealth is not the primary concern of all directors and some related punishments cannot guarantee it. Risk of terminating the contract can be a good incentive for maximizing stockholders' wealth. Job rotation of directors contributes to coordination between the goal of executive directors and stockholders as well as it increases the quality of leadership of directors (Fields, Lys, & Vincent, 2001). Majority of studies on the relationship between corporating performance and job rotation of executive directors were conducted by Murphy (1999), Hermalin *et al.* (1998, 2003), and Adamz and Hermaline (2010). Finkleshtine *et al.* (2009) conducted a study on determining job rotation intervals of executive directors and its effects on the executive directors' decisions. The obtained results indicate that firms with weak management have low quality of income. In these researches things like restatement, not restating or resignation of the auditor all suggested low quality of income. Generally, after restating the income, replacement of executive directors also will increase (Demerjian *et al.*, 2010). This is more consistent with theories of human resources management.

According to this theory, if human resource management is effective, the effective personnel replaces with ineffective ones. This makes directors to dissuade from manipulating financial reports. Results from the study of Arthur de *et al.* (2006) reveal that executive directors tend to file financial restatements (Arthaud-Day *et al.*, 2006). Although these results are consistent with results from Decie *et al.* (2006), theoretical framework used in both studies is significantly different (Deshmuk, 2009).

Results from the study of Arthur de *et al.* show that financial restatements not only increase the accuracy of corporating operations but also it reflect tendency of the firms to react to the crises resulting from removing the executive directors (Arthaud-Day *et al.*, 2006). Lend (2010) in a research examines personalities of directors who restate and find

some evidence that reveals job rotation of executive directors, accuracy of executive directors' restatement within a specific interval increases. The results of this study also show that using auditors and dependency of income in restatements serves as an incentive to change executive directors (Healy, 1985).

The study of Leon Miller (2008) indicates that inability in identifying deliberate and unintentional mistakes in components of income that are restated, can lead to wrong inferences (Hermalin, & Weisbach, 2003). Karapouf *et al.* (2008) found convincing evidence based on which almost all fraudulent directors lost their jobs. These finding are stronger for firms with an independent board of directors and large number of external stockholders (Goel, & Thakor, 2008). Menoun William found evidence based on which changing executive directors increases resignation of independent auditors that in turn can be an excuse for changing executive directors who are not able to solve problems of audition reporting (Klein, 1998). Results of the study of Fench *et al.* indicate that almost 60% of directors are responsible for manipulation of corporating income and therefore they will face different kinds of punishments such as limitation in future employment. Results from many studies reveal that increases in directors' job rotation enhances filing lawsuits about financial reporting. In contrast, Agraval *et al.* (1999) investigated 103 firms and the results showed that in firms with fraud, there is evidence of job rotation of directors. These results are surprising since disclosing fraud reduces the value of the firm and it is also a warning about punishing the directors.

Directors' replacement can restrict disclosure of firms about their debts since disclosed cases about fraud results in increasing the legal costs (Agrawal & Cooper, 2009). The research of Agraval *et al.* (2009) provides the following valid reasons about impossibility of evaluating the relationship between fraud and directors' replacement. First, it is likely that cost of replacing the fraudulent manager is forbidden in terms of human resources department's credits. Secondly, firms may try to solve accounting problems through improving the level of internal controls as incurring direct and indirect costs to solve accounting problems in firm is forbidden and disclosing accounting problems may not lead to change in management. Thirdly, restatements may result in bad impacts on credit of firm's capital. In these cases, gross profit of directors' replacement may be less. Fourth, governing mechanisms may

not be strong enough to lead to quick replacement of directors (Agrawal & Cooper, 2009).

Similarly, results of Fondeberg Tirol 's study showed that presenting excessive profits by firms does not have any influences on the executive directors' replacement (Beneish, 1999). Based on the findings of this study, fraudulent activities do not have any significant effects on executive directors' replacement. However, results of some studies show that low quality of profit or being afraid of low quality of profit can stimulate board of directors to change the directors. The quality of income index can also answer the question of 'Do accepted principles of accounting of executive directors who manipulate income, consider any punishments for them?' Finally, there is no consensus in ideal re-statement of quality of financial reporting.

Fondeberg and Tiroll argue that description of responsibilities based of which they must work is because of continuing the activities of the firm. Management can minimize ability of fraud in the firm through appropriate monitoring of the activities because deciding on whether to keep or dismiss people greatly depends on their performance in the past (Fama, 1980).

Through using three indices of job security, (i.e. competition, product stability, and income stability), Ahmed *et al.* (2011) tried to correct the study of Defound and Park. The findings of this research support hypothesis in which there is a relationship between job security and leveling out the profit.

Discussion

After all, the studies on how quality of financial reporting effects on the probability of executive directors' replacement reveal some complicated evidence of the effectiveness of human resource management. Furthermore, results of the researches indicate that human resource management must play an active role in external corporating governance to prevent opportunism of directors. Future research must focus on whether human resource management is a supplement or replacement for internal governance by considering quality of financial reporting.

"Success of a teacher is not to suggest mislead people that they never lose their success (Bill Gates). 'Try not to become a man of success, but rather try to become a man of value' (Albert Einstein). On the personality characteristics of directors focusing on the question of 'how do psychologists justify the di-

rectors' decisions based on their personality characteristics and the effect of these decisions on the output of financial reporting'.

Theoretically, the first theory on personality characteristics of directors was proposed by Hebirik and Masoun. This theory states that personality characteristics of chief directors influences their decisions (Goel, & Thakor, 2008). One of the main characteristics of directors is too much self-confidence. Therefore reviewing the concept of too much self-confidence and its effects on financial reporting seems vital.

After 1960, the term 'too much self-confidence' has widely attracted attentions. Since 1990's this term has been used in financial and economical fields to elaborate abnormal behaviors. According to psychology, too much self-confidence is when people think they are more important than others. This causes that they think too positively of themselves. In other words, too much self-confidence is a kind of positive perception error.

Too much self-confidence as a psychological characteristic may contribute to discriminative behavior (positive) about a certain subject. For example, in cash flow it can lead to exaggerating about reporting the cash. In addition to controlled perception error, the concept of too much self-confidence includes (Adams, & Ferreira, 2009). Better interpretation of the mean (Adams and *et al.*, 2010) unreal optimism, and controlled perception error. Too much self-confidence of the directors may result in deviation in investment decisions and reducing payable profit. Although too much self-confidence is considered as behavioral deviation, it is the most important factor in directors' promotions (Francis *et al.*, 2008).

The concept of too much confidence has recently used in accounting researches. Higherbar and Yang (2010) provided evidence that show too much confidence of directors makes them to tend to overstatement of profit, issuing optimistic predictions and profit management in order to achieve expected profit (Goel, & Thakor, 2008).

Leo (2010) conducted a research on management predictions by considering the differences between too much self-confidence and too low self-confidence of directors. Other researchers also investigated the effect of directors' predictions with too much self-confidence on the market reaction. The results showed that wrong predictions have a significant effect on the market.

Hillery and Hissary (2011) studied the effect

of too much self-confidence on directors' predictions about profit for four three-month intervals. The results revealed that directors' too much self-confidence can reduce accuracy in predicting profit for the next three months. Natar and Zechman provide evidence that indicate directors' too much self-confidence have fraudulent actions. The findings confirmed that directors' too much self-confidence requires profit management in intervals in which directors are not sure about future predictions. Habib *et al.* (2012) examined the effect of too much self-confidence on strategies related to profit management and whether the relationship between these two changes in the process of global financial crisis. The results of this research revealed that directors with too much self-confidence manage and report profit with less accuracy (Gilligan, 1982). Other researchers tried to study the effect of financial directors' individual characteristics such as risk-taking and too much self-confidence on quality of financial reporting. The results of their study showed limited evidence about the effect of financial directors' individual characteristics on their reporting choices. Karslo *et al.* (2011) reexamined the relationship between the role of executive directors in selecting board of directors' members and restatements. They provided some evidence for the effect of executive directors on selecting board of directors which has omitted minimum profits. In contrast, results from other researchers work indicate that executive directors must intervene directly in selecting board of directors and do not select them by chance. They believe that these interventions make the firm to develop.

Recent researches on directors' too much self-confidence introduced a new chapter in understanding management accounting better. The present literature shows a negative viewpoint on too much self-confidence in management decisions but this literature must be used cautiously. Role of executive directors in the process of selecting board of directors should be strong.

Goul *et al.* (2011) believe that selecting women as director is appropriate because

- (a) having moral judgment
- (b) maintaining expected value of stockholders.

According to organizational theories, the results of performance of female directors in comparison with male directors have better consequences for the organization. Presence of women in management positions can improve the performance of the organization and facilitate decision making. It

also increases quality of financial information and as a result causes external stockholders, financial analyst, Medias and the public taking positive attitudes towards the firm.

Beramer *et al.* (2009) believes that presence of women in management positions increases sense of interaction in organization. The results show that absence of women in management sections can lead to financial crisis. For example, Baroness Hug head of British financial council believes that sex variety in composition of board of directors can mitigate the dangers arising from group thinking.

Many studies have been conducted on moral differences between two sexes. The results of these researches show that there are great differences between men and women attitudes in business and trade behaviors. Men are more interested in economic profits and achieving the result at any cost even violating the rules, but women tend more to interaction, sustainable discipline and consultation in relations.

Adam *et al.* (2009) believe that elaborating different aspects of the role of sex in financial reporting needs more researches. They also believe that women tend to be actively present in activities more but men tend to monitor the activities. Women have higher insights. Results from other researches show that female accountants involve themselves less in financial managements. Behavior of men and women are different in accounting. For example, results of Goul *et al.* (2011) study indicated that presence of women increases qualitative level of reported incomes (Gervais, & Odean, 2001). These results also show that sex variety improves the performance of the firm and raises price of shares (Gervais, & Odean, 2001). Other researches also indicate differences between two sexes but limited numbers of researches have been conducted investigating on personality characteristics of executive directors which examine the organization issues.

Quality of financial reporting is too much important in big markets. Therefore, paying attention to effective factors in enhancing quality of reporting of companies listed in stock market in all countries is vital. In another study, Goul *et al.* (2011) seeks to answer the question of 'Does management of women in financial issues better than men?' The results showed that there is no great difference between financial performance of men and women. Their study also examined the relationship between sex and quality of income in markets in China.

This section examined the effects and role of sex

variety in quality of accounting information. Over the past decades using female directors in management positions has been increased. Sex variety in management discussions improves and enhances quality of financial and accounting information. A lot of researches have been conducted researches due to raising these discussions. The main purpose of conducting such studies is identifying the effects of sex variety of directors on financial reporting and structure of the capital. The results revealed that sex variety provides the development of the firm.

Conclusions

This research tried to review the studies on the relationship between personality of executive and financial directors of firms. It focuses on the followings:

1-Does proper human resources management prevent directors from manipulating financial reports?

2 -Does directors' too much self-confidence influence on financial reporting such as profiting statements and presenting unreal predictions in order to justify fraudulent actions? 3-does examining executive and financial directors' gender effect on financial reporting?

Findings of this research show the effect of job rotation of directors on improving financial reporting. These findings are consistent with some studies and in contradiction to others. This study also shows the effect of sex variety on financial reporting. In other words, sex variety develops the firm and it is effective on maintenance of firm's activity. Moreover, it examined the effect of personality characteristics of executive and financial directors on financial reporting. Findings of this research can be a good incentive to conduct future studies. Finally, it is recommended to consider the findings of this research with caution.

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